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Lifting the Natural Resource Curse
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Many of the world's poorest countries possess significant reserves of oil and other natural resources. Yet numerous academic studies show that, controlling for income level, countries that are highly dependent on revenues from oil and other minerals score lower on the U.N. Human Development Index, exhibit greater corruption, have a greater probability of conflict in any five-year period, have larger shares of their population in poverty, devote a greater share of government spending to military spending, and are more authoritarian than those with more diverse sources of wealth.

This occurs because the income from these resources is often misappropriated by corrupt leaders and officials instead of being used to support growth and development. Moreover, such wealth often fuels internal grievances that cause conflict and civil war. This pattern is widely referred to as the "natural resource curse" -- natural resource wealth creates stagnation and conflict, rather than economic growth and development.

The natural resource curse is vividly illustrated in Angola, where an International Monetary Fund fiscal audit has been unable to account for hundreds of millions of dollars of oil revenues. In Nigeria, Cameroon and the Republic of the Congo, oil wealth has failed to generate development, and has instead generated deep-seated corruption that retards growth. Sudan is marked by strife over oil. And in Aceh, Indonesia, regional separatism has been fanned by secrecy about oil payments and public misunderstanding about their scale.

The problem of natural resource-related corruption also afflicts the Western Hemisphere. Ecuador is rich in oil but ranks as one of the most corrupt countries in Latin America. And accumulated resentments over the way Venezuela's oil wealth has been distributed have contributed to the political divisions in that country.

Finally, Saddam Hussein's Iraq is another tragic example of the natural resource curse. Iraq is abundantly rich in oil, having proven reserves of 112 billion barrels, which represent 10.8 percent of the world's total proven resources. Moreover, many believe that Iraq's potential may be far greater, as the country is relatively unexplored due to years of war and sanctions. But like many other countries rich in natural resources, Iraq has failed to benefit from its oil wealth. Instead, Saddam Hussein's regime used petroleum revenues to finance domestic political repression, military aggression and state looting – exemplified by wasteful spending on presidential palaces and transfers of funds to personal foreign bank accounts. These revenues also bankrolled the war with Iran and Saddam's invasion of Kuwait.

The natural resource curse represents the pre-eminent obstacle to democracy and development in much of the developing world. Moreover, the problem has the potential to worsen in the coming decade. In the Caspian Basin, the completion of the Baku-Tiblisi-Ceyhan pipeline will increase oil revenues in Azerbaijan; the now completed Chad-Cameroon pipeline will have oil revenues ramping up in Chad; and off the coast of West Africa, the Gulf of Guinea has some of the most promising oil exploration prospects anywhere in the world. None of these areas have histories of strong democratic governance, and all therefore risk being afflicted by the natural resource curse.

There is no “silver bullet” to remedy the problem, but there are a range of measures that the U.S. and other developed nations, multilateral institutions, and developing countries themselves can all take to increase accountability and transparency. In a world lacking strong institutions of global governance, the U.S. has a special responsibility to back international cooperation and collective action. For without coordinated interventions, corruption will just move between jurisdictions – like squeezing air in a balloon.

In addition, putting a stop to the national resource curse would serve U.S. national security interests, both by reducing strife around the globe and by addressing the poverty and political instability caused by this tragic pattern.

Publish What You Pay

Corruption is the enemy of both free markets and democracy. Corrupt government promotes corrupt business, and corrupt business promotes corrupt government. This inexorable logic means that citizens and investors everywhere have a public and private interest in combating corruption by increasing transparency and accountability.

When oil and mining companies fail to disclose payments to governments, for example, it is easier for government officials to steal and more difficult for citizens to hold officials accountable. Recognizing this, philanthropist George Soros and his Open Society Institute have been working for the last 18 months to address the problem of corruption connected with natural resource extraction through an international “Publish What You Pay” campaign.

This initiative proposes legislation requiring publicly-listed oil and mining companies to disclose information about payments to government, as a condition of stock exchange listing. Relevant payments that would have to be disclosed include tax payments, royalty and license fees, revenue sharing and payments-in-kind, forward sales of future revenues, and commercial transactions with government and public sector entities.

Investors and citizens everywhere stand to benefit from PWYP. Reducing corruption will stimulate investment and growth, which is good for business and good for developing countries. It will also strengthen the rule of law and property rights, thereby attracting investors. Reducing corruption also lessens the likelihood that multi-national businesses will get drawn into corrupt activities, which can damage their reputation and expose them to legal problems, both in country and back home.

PWYP is part of a larger international governance agenda needed to address corruption in today's globalized economy. The PWYP campaign has the support of over 130 groups from all around the world. Several large natural resource extraction companies, including BP, Shell, and Newmont Mining, have expressed positive views about it. In addition, a group of major European and American asset management funds representing $3 trillion has endorsed greater company transparency regarding payments to government.

Regrettably, U.S. oil companies have resisted PWYP, claiming that corruption is a governmental problem. But the reality is that corruption is a *systemic* problem, and by doing nothing to end it, such companies are de facto fencers of oil and other natural resources.

If the G-8 were to ignore such opposition and collectively agree to make PWYP part of their securities laws, it would immediately cover all major financial markets that are the principal source of major pools of development finance. This approach would quickly become the benchmark for capital market integrity, and those developing country governments that barred companies from disclosing payments would soon find the supply of capital drying up.

Extractive Industries Transparency Initiative

PWYP is a mandatory disclosure measure targeted on publicly-traded natural resource companies. But it does not address non-traded companies or state-owned natural resource companies; nor does it address governments themselves. The Extractive Industries Transparency Initiative, announced by British Prime Minister Tony Blair at the World Summit on Sustainable Development in Johannesburg, in September 2002, complements PWYP by broadening the web of coverage to include these actors.

The EITI aims to establish voluntary compacts between country governments and companies regarding natural resource revenue transparency. Using standardized reporting templates, companies would report what they pay governments and state agencies, including state-owned oil companies and provincial governments. State oil companies would also report what they receive from companies and pay governments, while governments are to report revenues received from private sector and state-owned natural resource companies. This architecture is intended to create a web of double-entry checks.

The strength of the EITI is its broadening of the scope of reporting coverage to include state oil companies and government. Its weakness is that it is a voluntary compact, so that bad cases such as Angola and the Republic of the Congo are unlikely to participate.

Publish What You Lend

It is not just the current revenues of developing countries that are subject to theft. Because modern financial markets enable governments to borrow significant amounts of money that effectively convert future revenues into cash today, they can facilitate the looting of the public purse. This can happen in several different ways.

Leaders of countries may incur large debts, saddling future governments with the burden of making the interest and loan principal repayments on them. In effect, financial markets can enable corrupt governments to steal from the future.

Another way financial markets facilitate this kind of theft is by borrowing against secured assets. Thus, valuable assets can be converted into cash today without ever being publicly sold. And once again, future governments and taxpayers are left with the tab.

In government-owned extractive industries, a related practice is to forward-sell future output. For instance, state-owned oil companies may forward-sell future production, getting cash today in return for promising to deliver oil in the future. In effect, these sales represent borrowing against future production, and they, too, provide a means by which governments can be stripped of future revenues.

The problem is compounded by the fact that financial transactions are often shrouded in secrecy owing to the banker's culture. Publish What You Lend would have national governments require by law that all banks, financial intermediaries, and business enterprises, that make loans to or engage in forward purchases with governments and state owned enterprises, publish details of these transactions and report them to the IMF. These published details would include a description of the purpose of the transaction, the value of the principal involved, fee amounts in both absolute terms and as a percentage of the contract value, and the terms of the transaction including effective interest rates and term to maturity. These details would be recorded in a central registry maintained by the Fund that would be open to public inspection.

The IMF, the World Bank and the other multilateral development banks would also be obliged to abide by these same reporting requirements. Governments would also publish details of all official country lending, and report these details to the IMF to be similarly recorded in the central registry.

By mandating disclosure of loans and forward contracts, PWYL can serve as a powerful instrument for blocking illegitimate use of financial markets. Countries will benefit from PWYL, but so too will international investors. This is because loans that finance corruption add to the cumulative obligation of governments, but they do nothing to increase tax revenues. Consequently, they reduce the likelihood of repayment to bona fide lenders. Reducing financial market looting will therefore benefit these lenders. At the same time it will lower interest rates for developing countries. Corrupt loans lower the likelihood that lenders will be repaid, causing lenders to raise interest rates to cover this increased risk. Reducing such loans will therefore cause lenders to lower their rates.

Odious Debt

Another important measure for guarding against looting via financial markets is the legal doctrine of odious debt. The core idea is that where: (1) loans are made to illegitimate regimes, such as those that come to power undemocratically; (2) loans are not used for the benefit of the people; and (3) lenders could reasonably have known about conditions (1) and (2), then such loans can be deemed illegitimate and unenforceable.

Adoption of the doctrine of odious debt would quickly reduce looting via financial markets. Lenders would have an incentive to conduct proper due diligence, write strict loan covenants, and then monitor the loans to ensure that the covenants are abided by. It would also be good for both democracy and economic development. Illegitimate, undemocratic governments that come to power by coup d'etat or civil war, and then refuse to submit to the democratic process, would be frozen out of international capital markets. Side-by-side, stricter monitoring by lenders would ensure that loans are used for developmental purposes, rather than looted.

Opponents claim that adoption of the doctrine of odious debt would reduce the supply of credit to developing countries, and drive up its price. Economic logic suggests otherwise. Total lending could be less, but only because corrupt lending is reduced. Productive "good" lending would increase dramatically. Improved loan monitoring will increase the productivity of loans, as creditors will have an incentive to ensure that loans are used in accordance with loan agreements. These effects will also lower the cost of credit by increasing the likelihood that lenders get repaid.

Corruption exerts a significant negative externality by raising overall indebtedness while doing nothing to increase a country's capacity to repay. In effect, corruption dilutes the asset protection available to other creditors, and they protect themselves by raising their required interest rate. By holding creditors responsible for corrupt loans in cases where lenders failed to do due diligence, corrupt loans can be diminished and honest lenders can lower their required interest rate.

Lastly, the doctrine of odious debt can help starve autocratic kleptocratic governments out of existence by reducing the amount of finance available to them. A 2002 study by economists Bruce Bueno de Mesquita and Hilton Root demonstrates how providing funds to such governments helps them stay in power by enabling them to pay off supporters. This is especially true of loans and foreign aid to these governments which come in the form of hard currency. Reducing such funding can therefore undermine political support for these governments.

Stolen Asset Recovery

Another area where legal action is urgently needed concerns the recovery of stolen assets. Monies looted from developing countries are usually placed within the international banking system. Yet, all too often, it is difficult for countries to recover these assets. Tougher provisions, that facilitate recovery and make it harder to hide assets, are needed. The international community has clamped down on money laundering and terrorist financing. So too it must clamp down on corruption by facilitating the recovery of stolen assets. These assets leave behind a paper trail that can be followed, and enhanced recovery of looted assets would reduce the incentive to loot. The experience with money laundering and terrorist financing shows that recovery of stolen assets is feasible. All that is needed is political will.

The IMF and the World Bank Group

The IMF and the World Bank also have an important role to play in combating the natural resource curse. As important large lenders, these two institutions have significant power that can be leveraged to improve governance and reduce corruption. The Fund and the Bank can both help by funding technical assistance programs and developing standards for fiscal transparency and good fiscal practice. Governments must publish what they earn and publish what they spend, and government purchases should be governed by transparent contracting procedures that have open tendering, with contracts going to the bidder providing the highest quality at the lowest price. The IMF also has an important role to play in the EITI initiative as the Fund is envisaged to be the aggregator, totaling company payments to national governments to get an overall country figure.

However, the key contribution the IMF and World Bank can make is to institute requirements for transparent reporting of government revenues from natural resources. Given that countries need financing from the Bank and the Fund, these institutions have significant leverage. A good example of this is the World Bank's groundbreaking handling of financing of the Chad–Cameroon oil pipeline, which it has made conditional on Chad's compliance with strict accounting and spending management. Similarly, at the IMF's urging, Azerbaijan and Kazakhstan have established national oil stabilization funds that aggregate much of their oil revenues (see the "Oil Stabilization and Savings Fund" section below).

Building on these initiatives, *all* Fund and Bank country assistance and lending programs – especially those connected to the extractive sector – should be conditional on recipient countries transparently reporting their revenues. This approach should apply to all activities -- development assistance loans to countries, loans to companies via the International Finance Corporation, or investment guarantees provided via the Multilateral Investment Guarantee Agency.

Lastly, Publish What You Pay can play a valuable role helping the IMF and the Bank. Given the often weak administrative capacities of developing countries, PWYP can help provide a double-entry check on government revenues, since companies' reported payments should match governments reported natural resource revenues from companies (including state-owned companies). This reveals how different policies work together synergistically.

Export Credit Guarantee Agencies

Another important mechanism for tackling the natural resource curse is via the various export credit guarantee agencies, such as the World Bank Group's Multilateral Investment Guarantee Agency. These agencies play a critical facilitating role by insuring trade and investment projects. Absent this publicly provided insurance, many private sector transactions would not take place, making these agencies an important lever for change.

Even more important, these agencies often insure large natural resource development projects. They are therefore involved at the *outset* of the project, before revenue streams come on line. A major difficulty in getting governments to change is that they have little incentive to once revenues are on stream. Insisting on change when projects first begin is the strategically sensible moment, and export credit guarantee agencies are well placed to do that.

Oil Revenue Distribution Funds

The transparency and accountability inherent in good governance – are the keys to warding off the natural resource curse. However, developing efficient states with honest governments takes much longer than developing oil fields and building pipelines. Oil revenue distribution funds that directly distribute revenues to citizens represent an important means of addressing this conundrum, as they can be established relatively quickly.

Perhaps the best example of an ORDF can be found close to home, in Alaska (though that one operates on a relatively modest scale). But the approach holds great promise for developing countries.

By side-stepping government interference, ORDFs reduce the space for official corruption. But they also provide a host of other economic and political benefits. First of all, income distribution is highly unequal in many developing countries, and this inequality is bad for growth and democracy. The payment of a flat oil dividend to all citizens would constitute a progressive redistribution, helping equalize the distribution of income, and providing seed money for poorer citizens to become entrepreneurs. And because the dividend would constitute a regular source of income, it would also provide collateral for ordinary citizens to finance small business investment projects. This, in turn, would stimulate development of credit markets, which are so essential for development.

Another problem that frequently afflicts oil-rich countries is that they suffer from economic activity that is skewed toward excessive government, a feature which also promotes corruption. Directly paying revenues to citizens would help rectify this structural imbalance. Finally, on the political side, citizens would have an incentive to become politically engaged to protect the dividend paid by the ORDF and to ensure that state-owned oil industries operated efficiently so as to maximize the dividend.

One common objection to distributing oil revenues is that it would starve developing country governments of money needed for infrastructure building. However, this concern is misplaced. The goal of development is to build lasting political and economic development, and trade-offs are always present, given the scarcity of resources. Directly distributing a chunk of oil and mineral revenues to citizens may be the best possible development investment, yielding higher returns than infrastructure spending in terms of creating political ownership and economic dynamism.

An ORDF would seem to be particularly appropriate for Iraq. In a recent *New York Times* op-ed (April 9, 2003), Steve Clemons of the New America Foundation has proposed that Iraq establish an Alaska-style oil fund that would pay annual dividends to the citizens of Iraq. But given Iraq's current condition of economic collapse and history of autocratic kleptocratic governance, it makes better sense to pay a significant portion of oil revenues to Iraq's citizens now. In addition, a companion fund should be established that would distribute a share of oil revenues to provincial and local governments. This second fund can ensure a fair regional distribution of revenues, thereby reducing the potential for regional grievances which can lead to civil war.

Paul Bremer, the top U.S. administrator in Iraq, has recently expressed support for such a fund (*New York Times*, July 13, 2003). But while it is appropriate for Bremer to contemplate some form of temporary distribution during the transition to constitutional democracy in Iraq, any permanent arrangement must be the decision of the Iraqi people. This is the only way an arrangement can have lasting political legitimacy.

Oil Stabilization and Saving Funds

Oil stabilization and saving funds represent another approach. An accounting device, OSSFs provide a separate account into which oil revenues are paid. Their purpose is to shield the government budget from the revenue uncertainty and volatility of natural resource revenues, and to save for future generations given that natural resources are often non-renewable. Azerbaijan and Kazakhstan are two countries that have recently established national oil stabilization funds.

Such funds can make a contribution to improved governance, particularly by contributing to greater transparency of natural resource revenue flows. They can also help guard against the problem of "Dutch disease" by ensuring that some of the revenues are directed to accumulation of foreign assets. This helps prevent exchange rate appreciation, which undermines international competitiveness. Finally, to the extent that government spending is tied to fund revenues, they can contribute to fiscal discipline.

These are real benefits. However, stabilization funds also have significant limitations. For example, there is no guarantee their revenues will be used for the benefit of citizens. Furthermore, governments can avoid the putative income constraint by borrowing. The bottom line is that to work well, oil stabilization funds need good governance. However, the funds do not themselves produce the institutional and political change needed for good governance. This limits their usefulness in worst-case countries.

Privatization

Another widely canvassed solution to the natural resource curse is privatization, the sale of state-owned oil industries and oil production rights to private-sector investors. Privatization has been a big part of the development agenda pushed by the IMF and the World Bank over the last two decades. The argument is that it promotes productive efficiency by restoring the profit motive. It also resonates with political agendas aimed at shrinking state economic involvement.

In practice, however, the history of large-scale privatization has been fraught with failure. In many instances, the majority of the assets end up in the hands of multinational oil companies. This is particularly evident in the former Soviet Union, where the selling-off of industry created a new oligarchy, and the state failed to get its money’s worth.

Even if the privatization process is conducted legitimately at fair market prices, there still remains the problem of what to do with the revenues. If handled properly, privatization sale proceeds should equal the net present value of all future profits. In effect, privatization converts future profits into a lump sum. But this conversion gives kleptocratic governments an even larger sum to spend and steal -- a case of jumping from the frying pan into the fire.

For this reason, as with oil stabilization funds, privatization works best in countries where governance is strong. This limits the usefulness of privatization.

Summary

The natural resource curse represents an enormous impediment to development. Yet it is important to realize that it is not natural resources per se that are the problem;

rather, it is lack of good governance and democracy. Remedying this institutional failure requires changes of law and practice but does not require huge resource investments. The measures discussed in this article involve minimal cost but promise enormous productivity gains. From this perspective, the rate of return payoff is astronomical.

Lifting the natural resource curse would be like economic oxygen for developing countries. It would help ensure that existing resources are used efficiently, and the resulting improvement in the economic atmosphere would attract additional resources, making for better growth prospects.